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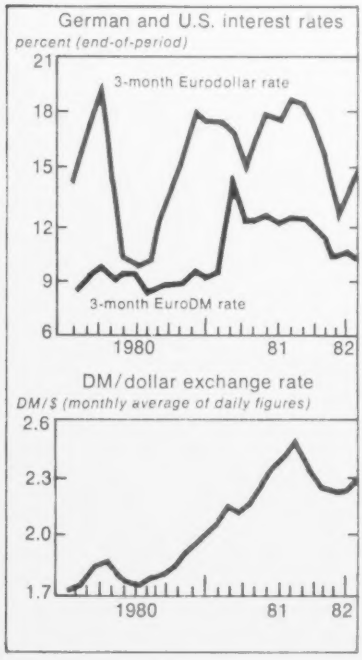
Why Did the Europeans Lower Interest Rates?

The recent small decline in European interest rates, led and coordinated by the German Bundesbank, was somewhat perplexing to the international financial community. It marks the first such reduction in two years to be undertaken in the face of rising U.S. interest rates and a consequent strengthening of the dollar on the foreign exchange markets. Previously, Europe's central banks chose to defend their exchange rates when faced with a strong dollar. They did this by maintaining or even raising interest rates, despite the sometimes considerable cost to their domestic economies in the form of falling capital investment and reduced economic activity. Such policy was predicated on the view that a rising dollar would boost domestic prices by increasing the local-currency cost of dollar-denominated imports—particularly oil—and thus threaten to set off a wage-price spiral. The costs of eventually arresting such a spiral, in terms of lost output, were seen to exceed the costs of stabilizing the exchange rate.

Interest-rate differentials and the value of the dollar



At first sight, the recent move to lower rates would seem to indicate a marked policy shift. Closer examination, however, suggests that this view may well be overstated. For one thing, the European move was small; key interest rates were reduced by only one-half of a percentage point. In addition, policymakers believed that the exchange-rate cost of their interest-rate reduction would be low, based on such signs as the sharp turnaround in Germany's current-account balance and doubts about the durability of the recent rise in U.S. interest rates. Furthermore, the weakness of dollar-denominated commodity prices—including oil—means that a weakening of Europe's currencies against the dollar now carries a smaller inflationary impact than previously.

The European move can therefore be explained as much by a shift in the trade-off facing European policymakers as by a major shift in policy. That said, there is indeed some pressure for a change in policy emphasis stemming not only from the duration of the European recession and the resulting sharp rises in European unemployment rates, but also, from the lack of signals indicating an imminent domestically-led upturn.

The real test, however, would come if U.S. interest rates were to rise substantially later in the year. Europe would then be faced with an unpleasant choice: either accept a higher rate of imported inflation or risk aborting an incipient economic recovery by defending the exchange rate.

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Strong retrenchment inevitable for Ireland in light of continuing economic ills.

No matter what the outcome of this week's general election, Ireland faces bitter medicine in bringing its economy back to health. The severity of the country's economic problems is beyond dispute: Inflation is now running at an annual rate of 23% and shows few signs of abating; unemployment has reached 11% and is still rising; the deficit on the current account of the balance of payments in 1981 equaled an estimated 8% of total GNP and seems likely to deteriorate further; the country's foreign debt has risen to over 40% of GNP; and the government's huge deficit has expanded to nearly 17% of the national product. Although the Fine Gael government was unsuccessful last month in its attempt to introduce an exceptionally tough budget aimed at alleviating these ills, almost everyone—including the leader of the opposition party—recognizes that a policy of strong retrenchment is needed. Thus, the bulk of the proposed budget's restrictive measures are likely to be retained, irrespective of who wins the election.

Kronor devaluation prompts narrowing of Swedish trade deficit, but rekindles inflation.

The Swedish economy is still responding favorably to the effects of the 10% devaluation of the kronor in September 1981. Interest rates have fallen as the pressure on the exchange rate has diminished, and an encouraging export performance is helping to offset weak domestic demand. Preliminary figures indicate the trade deficit dropped to kr. 2 billion in 1981, substantially lower than 1980's kr. 10.9 billion gap. Growth is likely to pick up again in 1982 after last year's small GNP decline. But, despite the rise in imports that will undoubtedly follow the upturn in domestic activity, the current account of the balance of payments is not expected to deteriorate from the 1981 level. There is, however, also a dark side to the effects of this policy. The devaluation has worsened inflation, and in order to avoid a triggering of automatic indexation clauses the government was forced to reduce sales taxes. Indexation clauses for 1982 allow for wage increases if prices rise by more than 7% and it now looks certain that prices will in fact rise by much more. Thus, the country will continue to suffer from a wage-price spiral for some time to come.

Italian economy possibly past trough, but recovery will be slow.

Italy's volatile economy is sending out mixed signals. Provisional figures show that real GDP declined at a quarterly rate of 1.6% in the third quarter of 1981, following a 1.2% drop in the previous quarter. However, the third-quarter decline is attributable almost entirely to a seasonally adjusted 15% decline in industrial output in August which was then reversed in the following month. Moreover, the most recent figures, for November, show a sharp monthly rise. Survey data indicate a slight worsening in expected production, although exports appear to have performed strongly in the second half of 1981. All in all, it appears that the recession is now bottoming out but that the coming recovery will be sluggish. Monetary policy remains tight and high inflation continues to erode export competitiveness. For last year as a whole, real GDP is estimated to have declined by about 1%. And from the current perspective, a 1982 growth rate of about 1% appears likely.

Guatemala disrupted by political turbulence; outlook bleak.

Political turbulence has been the principal cause of the rapid deterioration of economic performance in Guatemala. Intense and growing political violence has not only shaken both local and foreign investor confidence leading to substantial capital flight, it has also hindered the ability to provide optimum care to crops and stifled trade flows and tourism. Compounding these internal problems have been high international interest rates and petroleum prices. At the same time, prices for major cash crops have been declining and no significant reversal is foreseen for the near future. Preliminary estimates indicate that real GDP growth slowed to 1.5% in 1981, down from 3.5% in 1980 and well below the 6% annual average growth for 1977-79. Guatemala's balance of payments, traditionally in good condition, deteriorated significantly in 1980-81; international reserves fell from $700 million at end-1979 to $190 million by November 1981. Until the political situation improves, prospects for stronger domestic and external performance are bleak.